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The Interplay Between Section 503(b)(9) Priority Claims and Preference Claims

SELECTED TOPIC

Section 503(b)(9) was added to the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) to protect trade creditors that sell goods to the debtor shortly before the debtor's bankruptcy filing. Section 503(b)(9) grants trade creditors an administrative priority claim for the value of goods they had sold to the debtor in the ordinary course of the debtor's business and that the debtor had received within 20 days of bankruptcy (the "20-day goods"). This priority claim increases the likelihood of the debtor's full payment for the 20-day goods that remain unpaid when the debtor files bankruptcy. It also enables trade creditors to avoid litigating many of the issues that have made reclamation rights illusory and ineffective.

The *COI* court held that the Section 503(b)(9) claimants could seek relief on their 20-day goods priority claims and include their priority claims as additional new value to reduce their preference liability.

While Section 503(b)(9) is a simple statute, that has not stopped debtors and secured creditors from seeking to eliminate or reduce the priority status sought by goods suppliers by litigating the numerous issues arising out of Section 503(b)(9). They include the meaning of

many of Section 503(b)(9)'s terms, such as "goods," "receipt" and "value," as well as the defenses to, and the timing of payment of, the priority claim. This article addresses two recent bankruptcy court decisions dealing with the interplay between Section 503(b)(9) priority claims and preference claims. What a lucky break for this writer whose two favorite subjects are trade creditors' Section 503(b)(9) priority rights and preference claims and defenses.

In the first case, *In re Commissary Operations, Inc.*, the United States Bankruptcy Court for the Middle District of Tennessee ruled that trade creditors could assert their Section 503(b)(9) priority claims as additional new value to reduce their preference liability. In the second case, *In re Circuit City Stores, Inc.*, the United States Bankruptcy Court for the Eastern District of Virginia, temporarily disallowed numerous trade creditors' Section 503(b)(9) priority claims up to the amounts potentially recoverable on preference claims asserted against them.

Well folks, these decisions do not represent the last word on the issues the courts had adjudicated. While the *Commissary Operations* holding is the first to allow a creditor to assert its 20-day goods priority claim as additional new value to reduce preference liability, other courts may rule to the contrary, particularly where the creditors' priority claims are paid post-petition. In addition, the *Circuit City* court's ruling that a debtor can invoke Section 502(d) to disallow the Section 503(b)(9) priority claims of creditors subject to

preference exposure is currently subject to appeal and motions for reconsideration, and has been rejected by other courts.

Lots to talk about here!

The Commissary Operations Case

Commissary Operations, Inc. (“COI”) filed Chapter 11 with the United States Bankruptcy Court for the Middle District of Tennessee on July 22, 2008. COI was a wholesale distributor of food and related goods to restaurant chains and franchises. COI first sought to reorganize its business in Chapter 11. However, shortly after its bankruptcy filing, COI decided to wind-down its business and sell its assets.

At the beginning of COI’s Chapter 11 case, more than 200 creditors asserted claims for allowance and payment of their Section 503(b)(9) administrative expense claims. COI sought to disallow these claims and commenced litigations against the Section 503(b)(9) claimants for the recovery of alleged preference payments.

Preference Claims and the New Value Defense

Section 547 of the Bankruptcy Code governs preference claims. A trustee or debtor-in-possession can avoid and recover a preferential transfer by proving that: (1) the debtor had transferred its property, such as by making a payment to or for the benefit of a creditor (Section 547(b)(1)); (2) the debtor made the payment for antecedent or existing indebtedness owing by the debtor to that creditor (Section 547(b)(2)); (3) the debtor was insolvent (which is presumed during the 90-day period) based on a balance sheet definition of liabilities exceeding assets when the debtor made the payment (Section 547(b)(3)); (4) the debtor made the payment within 90 days of the bankruptcy filing for payments to non-insider trade creditors, and within one year of the filing for payments to insider creditors, such as a debtor’s officers, directors, controlling persons and certain affiliated companies (Section 547(b)(4)); and (5) the creditor obtained a greater recovery from the payment than the creditor would have received in a Chapter 7 liquidation had the payment not been made (Section 547(b)(5)).

A preference defendant can reduce its exposure by invoking any one or more of the preference defenses contained in Section 547(c). The Section 547(c)(4) new value defense reduces a creditor’s preference liability to the extent the creditor had replenished the debtor and its bankruptcy estate by providing new goods and/or services on credit terms subsequent to the preference. The new value defense encourages creditors to continue to extend trade credit to their financially distressed customers by deducting from their preference exposure the invoice price of goods and/or services they had provided to the debtor, on credit pre-petition, following an alleged preference payment.

The Parties’ Arguments

The *COI* court addressed whether a creditor’s Section 503(b)(9) priority claim can be included as part of the creditor’s Sec-

tion 547(c)(4) new value defense to preference exposure. COI argued that its creditors would receive an improper double benefit if they can both obtain payment of their Section 503(b)(9) priority claims and then include their priority claims as part of their new value preference defense.

The Section 503(b)(9) claimants/preference defendants argued that their Section 503(b)(9) priority claims should be included as part of their new value defense for the following reasons:

- (1) The new value defense is determined on the bankruptcy filing date according to Section 547(c)(4). As a result, creditors should be permitted to include, as new value, invoices for *all* pre-petition deliveries, including 20-day goods, and should also be required to exclude from their new value defense new value that was paid pre-petition by an unavoidable transfer. By the same token, creditors cannot include post-petition extensions of credit as part of their new value defense and should not have to deduct from their new value defense pre-petition new value that was paid post-petition.
- (2) Creditors would be encouraged to continue to do business with financially troubled customers if they receive priority status for their Section 503(b)(9) 20-day goods claims and can assert that same claim as part of their new value defense to preference liability; and
- (3) Neither Section 503(b)(9) nor Section 547(c)(4) compels reducing a creditor’s new value defense by the amount of the creditor’s allowed Section 503(b)(9) administrative priority claim.

The *COI* court held that the Section 503(b)(9) claimants could seek relief on their 20-day goods priority claims and include their priority claims as additional new value to reduce their preference liability. The court noted that the Section 503(b)(9) claimants provided the requisite value to COI and its bankruptcy estate to qualify for the new value defense by selling and delivering the 20-day goods to COI pre-petition. COI benefitted by reselling these goods at a profit, satisfying its customers and maximizing its goodwill.

The *COI* Decision

The *COI* court also reasoned that creditors asserting their Section 503(b)(9) priority claims as additional new value to reduce their preference exposure should be treated no differently than creditors whose invoices were paid post-petition pursuant to a critical vendor order. The *COI* court relied on the ruling of another bankruptcy judge in the same court, in the *Phoenix Restaurant* bankruptcy case, that a creditor could assert, as new value, invoices for goods sold and delivered pre-petition and paid for post-petition pursuant to a critical vendor order. The *Phoenix Restaurant* bankruptcy court similarly concluded that Bankruptcy Code Section 547(c)(4) closes the preference window on the bankruptcy filing date. That limits a creditor’s new value defense to goods and/or services provided pre-petition and subjects any new value to reduction

only for pre-petition, not post-petition, payments. The *COI* court similarly held that Section 503(b)(9) claimants can use their 20-day goods priority claims as additional new value to reduce their preference liability, even if their priority claims were paid post-petition, since new value is determined as of the bankruptcy filing date.

The *COI* court also noted that neither Section 503(b)(9) nor Section 547(c)(4) requires goods sellers to reduce the amount of their available Section 547(c)(4) new value defense by the amount of their allowed Section 503(b)(9) priority claims. Section 503(b)(9) grants trade creditors a post-petition administrative priority claim for the value of the 20-day goods the debtor had received and that remained unpaid when the debtor filed bankruptcy. The Section 547(c)(4) new value defense encourages creditors to continue to do business with, and extend credit to, financially troubled debtors heading toward bankruptcy. These provisions do not require creditors to choose between asserting their claims for unpaid 20-day goods as a Section 503(b)(9) priority claim or as new value to reduce preference liability.

The *COI* court's ruling is the first known decision that allows a Section 503(b)(9) creditor to assert its 20-day goods claim both as a priority claim and as additional new value to reduce preference liability. However, other courts have refused to apply the Section 547(c)(4) new value defense to invoices that were repaid post-petition either by payment or return of the goods. For instance, the United States Bankruptcy Court for the Northern District of Illinois, in *In re Login Bros. Book Co.*, did not count, as new value, invoices for goods that the Chapter 7 trustee had returned to the creditor post-petition. The *Login Bros.* court and other courts concluded that creditors would obtain an improper windfall by receiving post-petition payment of their new value invoices and then using these invoices to reduce their preference liability. Creditors should receive a single benefit from their new value invoices—either payment of their claims or reduction of their preference liability. These courts also concluded that the new value defense should not apply because the debtor's bankruptcy estate did not benefit from goods delivered pre-petition that were subsequently paid for or returned post-petition.

The United States District Court for the Middle District of Tennessee, in *In re Phoenix Restaurant Group Inc.*, also precluded a reclamation creditor from obtaining relief on its allowed reclamation claim and then asserting that claim as additional new value to reduce the creditor's preference liability. While that holding suggests that Section 503(b)(9) creditors are not entitled to assert their priority claims as new value, the *COI* court noted that the debtor in *Phoenix Restaurant* did not benefit from the goods subject to reclamation because the creditor had retained an interest in, and the right to payment for, the goods by virtue of its reclamation rights. As a result, the debtor was obligated to segregate and return the reclamation goods, and could not resell the goods at a profit or incorporate them into a finished product for sale at a profit.¹ The *COI* court distinguished Section 503(b)(9) claim-

ants' lack of interest in the 20-day goods and the concomitant benefit to the debtor from its ability to resell them or manufacture them into finished product for resale.

So the jury is out on whether other courts will follow *COI*'s ruling that allows a creditor's Section 503(b)(9) 20-day goods priority claim to also count as new value to reduce the creditor's preference exposure.

The Circuit City Stores Case Factual Background

The debtors, Circuit City Stores, Inc. and affiliates, filed Chapter 11 cases on November 10, 2008. Circuit City was a specialty retailer of consumer electronics. Circuit City had employed approximately 39,600 employees and was operating approximately 712 retail stores and 9 outlet stores throughout the United States and Puerto Rico when it filed bankruptcy. On January 16, 2009, the court authorized Circuit City to conduct going-out-of-business sales at its remaining 567 stores. Circuit City completed these sales on March 8, 2009.

On November 12, 2008, the court set December 19, 2008 as the bar date for filing Section 503(b)(9) priority claims. On October 13, 2009, Circuit City filed two omnibus objections to Section 503(b)(9) priority claims. Circuit City relied upon Bankruptcy Code Section 502(d) to seek to temporarily disallow its Section 503(b)(9) priority claims by the amount potentially recoverable from these creditors as preferential transfers under Section 547. Section 502(d) states as follows:

“Notwithstanding subsections (a) and (b) of this section, the court shall disallow any claim of any entity from which property is recoverable under Section 542, 543, 550 or 553 of this title or that is a transferee of a transfer avoidable under Section 522(f), 522(h), 544, 545, 547, 548, 549 or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under Section 522(i), 542, 543, 550 or 553 of this title.”

A group of Section 503(b)(9) claimants opposed Circuit City's motion, arguing that Section 502(d) does not apply to administrative priority claims, including Section 503(b)(9) priority claims.

The Circuit City Decision

The *Circuit City* court temporarily disallowed creditors' Section 503(b)(9) priority claims up to the amount of the preference claims against them. The court concluded Section 502(d) applies to claims that must be *filed* under Section 501(a) of the Bankruptcy Code, which includes Section 503(b)(9) priority claims. The court relied upon Rules 3002(a) and 3003(c) of the Federal Rules of Bankruptcy Procedure. Bankruptcy Rule 3002(a) states:

“(a) Necessity for Filing. An unsecured creditor...*must* file a proof of claim...for the claim...to be allowed...” (emphasis added)

Bankruptcy Rule 3003(c) further states:

“(c) Filing Proof of Claim.

(2) *Who Must File.* Any creditor...whose claim...is not scheduled or scheduled as disputed, contingent, or unliquidated *shall* file a proof of claim...within the time prescribed subdivision (c)(3) of this title; any creditor who fails to do so shall not be treated as a creditor with respect to such claim for purposes of voting and distribution.” (emphasis added)

The court also relied on Bankruptcy Code Section 101(10) (A), which defines a creditor as an “entity that has a claim against the debtor that arose at the time of or before the [commencement of the bankruptcy case]...”

The *Circuit City* court treated the Section 503(b)(9) claimants as “creditors” because their claims arose pre-petition based on their sale and delivery of goods to *Circuit City* within 20 days of its bankruptcy filing. As creditors, they were required to file proofs of claim for their Section 503(b)(9) priority claims.² And, in addition to filing proofs of claim, they also had to file requests for allowance and payment of their administrative priority claims in order to obtain relief on their claims.

The *Circuit City* court was also concerned that the Section 503(b)(9) claimants would obtain an improper double benefit by obtaining relief on their priority claims and then using their priority claims as new value to reduce their preference exposure.³ The *Circuit City* court concluded that temporarily disallowing Section 503(b)(9) claims and holding them in abeyance pending resolution of all future preference litigations against the Section 503(b)(9) creditors would ensure that the Section 503(b)(9) claimants did not receive a windfall at the expense of other creditors.

Other bankruptcy courts, such as the United States Bankruptcy Court for the Eastern District of Michigan, in *In re Plastech Engineered Products, Inc.* and the United States Bankruptcy Court for the Northern District of Georgia, in *In re TI Acquisition, LLC*, have reached contrary holdings that a debtor cannot invoke Section 502(d) to disallow a creditor’s Section 503(b)(9) priority claim based upon the debtor’s preference claim against the creditor.⁴ These courts ruled that a Section 503(b)(9) priority claim is an administrative expense claim that is not subject to Section 502(d). Section 503(b)(9) claimants, like other administrative priority creditors, *cannot* assert their claims by filing a proof of claim under Section 501(a) of the Bankruptcy Code. Instead, they *must* file a request for allowance and payment of their administrative expense claims with the bankruptcy court. The bankruptcy court is then left to determine, after notice and a hearing, whether to allow and direct payment of the claims.

Several Section 503(b)(9) claimants have filed appeals from, and motions for reconsideration of, the *Circuit City* court’s ruling. It is, therefore, reasonable to infer that the *Circuit City*

court’s invocation of Section 502(d) to temporarily disallow Section 503(b)(9) claims based on *Circuit City*’s preference claims against these claimants is not necessarily the last word on the matter!

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Conclusion

Debtors and secured parties are becoming more litigious on Section 503(b)(9) issues in order to limit creditors’ recovery on these claims. The *COI* court’s decision that Section 503(b)(9) claimants could use their priority claims as additional new value to reduce preference liability is a win for the trade. On the other hand, trade creditors that hold Section 503(b)(9) priority claims would take exception to the *Circuit City* court’s holding that debtors can temporarily disallow Section 503(b)(9) claims based on pending preference claims against these creditors. Well, win a few, lose a few! Whichever side you find yourself on, you should rest assured that these holdings are not the last word on the matters in dispute! ●

1. Presumably, there must have been no dispute in *Phoenix Restaurant* that the reclaiming creditor was entitled to relief on its reclamation claim, unlike the many other cases where creditors are denied relief on their reclamation claims.

2. The Section 503(b)(9) claimants did file proofs of claim with respect to their priority claims, presumably relying on the court’s order setting a bar date for filing such claims.

3. The *Circuit City* court appears to be taking exception to the *COI* court ruling that a creditor’s Section 503(b)(9) claim can be asserted as part of the creditor’s new value defense to preference exposure.

4. The *COI* court, in an unreported order, also ruled that *COI* could not invoke Section 502(d) to disallow creditors’ Section 503(b)(9) priority claims based on preference claims against them.

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